Feldstein Merrill D

From: Feldstein Merrill D
Sent: Monday, July 15, 2002 10:48 AM
To: [redacted]
Cc: [redacted]; Casey Robert M
Subject: NSAR -- [redacted]

[redacted] -- We have reviewed the non-docketed significant advice that you prepared for the above-referenced case. We agree with your conclusion that the [redacted] paid by the taxpayer pursuant to the revolving credit agreement (and the costs of securing that agreement) must be treated as capital expenditures. However, we suggest certain modifications to your memorandum--

. (b)(5)(DP)

, (b)(5)(DP) [redacted]

Second, we are not certain that we agree with your conclusion that no amortization is appropriate in the case of these fees. We agree with your basic premise that the fees must be amortized over the term of the loans. However, if the term of the loans issued under the revolving credit agreement are restricted to the term of the revolving credit agreement, then the taxpayer may be able to demonstrate that the fees have an ascertainable useful life, and may be entitled to amortization over that period. On the other hand, if the revolving credit agreement does not limit the term of the loans, then your conclusion is correct, and the taxpayer would not be entitled to amortization. Thus, you should look to the terms of the credit agreement to make this determination. In this regard, you may want to consider the case, The Austin Co., Inc. v. Commissioner, 71 T.C. 955 (1979), which held, in part, that certain loan expenses had an indeterminable useful life, and therefore were not subject to amortization.

Finally, in response to the taxpayer's arguments that the quarterly facility/commitment fees equate with the cost of an option with a 3 month useful life, you may want to argue that the fees imposed in the agreement actually should be characterized as a payment schedule for the revolving credit agreement. As such, they relate to all the loans issued under the entire agreement and have a useful life commensurate with those loans.

I hope that these comments were helpful. If you have any questions, please call me at [redacted]
-- Merrill Feldstein

20249

Office of Chief Counsel
Internal Revenue Service
memorandum
CC:LM:F:[redacted]:POSTF-124411-02
[redacted]

date: July 3, 2002

to: [redacted], Financial Products Specialist
through [redacted], Financial Products Manager

from: Associate Area Counsel, LMSB, Area [redacted]

subject: **Large Case Advisory Opinion - [redacted] Corporation**

We are responding to your May 14, 2002 memorandum, in which you requested our advice regarding the deductibility of annual commitment fees paid by the taxpayer regarding a line of credit. For the reasons set forth below, we believe that the commitment fees paid by the taxpayer in [redacted] are not currently deductible because the taxpayer did not draw on the available funds in that year. Instead, the fees are deductible upon the expiration of the applicable commitment period. This memorandum should not be cited as precedent.

Issues

Whether the annual facility/commitment fees paid by the taxpayer are currently deductible. **UIL Nos. 162.00-00; 461.00-00**

Facts

In [redacted], the taxpayer entered into a Revolving Credit Agreement (the "Agreement"), under which it secured the right to utilize $[redacted] of total credit. Credit under the agreement was made available through the combination of a line of credit and letters of credit with a consortium of commercial lenders. Each bank was a party to and had varying commitment percentages under the Agreement.

Under the Agreement, the amount of available credit was reduced dollar-for-dollar by any borrowing or encumbrances under either the line of credit or letters of credit. Section [redacted] of the Agreement outlines the loan commitments as follows:

[redacted]

The term of the Agreement was [redacted] years. The facility fee (i.e., the fee for the availability of the revolving credit line) was computed under Section [redacted] as follows:

[redacted]

Regarding the issuance of a Letter of Credit, the taxpayer agreed to the following under Section [redacted]:

[redacted]

In [redacted], the taxpayer incurred $[redacted] in costs to secure the Agreement. The taxpayer capitalized these costs and amortized the amount over the [redacted]-year period ($[redacted] annually) for federal income tax purposes.

Between [redacted] and [redacted], the taxpayer had outstanding indebtedness under the line of credit with loan balances ranging from $[redacted] to $[redacted]. See Exhibit A, Schedule, attached hereto. In [redacted], the taxpayer satisfied its indebtedness under the line of credit with proceeds [redacted]. The taxpayer did not utilize the line of credit after [redacted].

Between [redacted] and [redacted], the taxpayer also utilized letters of credit with total credit balances ranging from $[redacted] to $[redacted]. Under the terms of the Agreement, total credit utilization and remaining credit available was determined with reference to both the line of credit and letters of credit. In other words, the total combined amount could not exceed the $[redacted]. Although the taxpayer was "cash rich" during the years [redacted], [redacted], and [redacted] and did not need to borrow funds to operate its business, [redacted].

In [redacted], the taxpayer paid Facility/Commitment fees of $[redacted] relative to the line of credit. Under Section [redacted] of the Agreement, the taxpayer paid these fees quarterly in arrears. This amount was expensed for financial reporting and federal income tax purposes.

Discussion

I.R.C. § 162(a)[1] provides for a deduction of all ordinary and necessary expenses paid or incurred during the taxable year in carrying on a trade or business. Section 461(a) provides that the amount of any deduction or credit shall be taken for the taxable year that is the proper taxable year under the method of accounting used in computing taxable income. If an expenditure results in the creation of an asset having a useful life that extends beyond the close of the taxable year, such expenditure may not be deductible, or may be deductible only in part, for the taxable year in which made. Treas. Reg. § 1.461-(a)(2).

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[1] All statutory section references are to the Internal Revenue Code in effect during the taxable year at issue.

In Rev. Rul. 81-160, 1981-1 C.B. 312, the Service announced its position regarding the timing of deductions for loan commitment fees. In that ruling, the Service revoked its earlier position, announced in Rev. Rul. 56-136, 1956-1 C.B. 92, that loan commitment fees or standby charges are deductible under section 162 when paid or incurred, depending on the taxpayer's method of accounting.

Both Rev. Rul. 56-136 and 81-160 involved commitment fees incurred pursuant to a bond sale agreements, under which funds for construction were made available in stated amounts over a specified period. In revoking Rev. Rul. 56-136, the Service characterized the fee not as an interest charge or service charge, but rather a charge for the acquisition of a property right. From this, the Service concluded in Rev. Rul. 81-160 that such fees are not currently deductible when paid or incurred, but must be deducted ratably over the term of the loan to which they relate, provided the available funds are drawn during the year in which the deduction is taken. As stated in the ruling,

> [a] loan commitment fee in the nature of a standby charge is an expenditure that results in the acquisition of a property right, that is, the right to the use of money. Such a loan commitment fee is similar to the cost of an option, which becomes part of the cost of the property acquired upon exercise of the option. Therefore, if the right is exercised, the commitment fee becomes a cost of acquiring the loan and is to be deducted ratably over the term of the loan. See Rev. Rul. 75-172, 1975-1 C.B. 145, and Francis v. Commissioner, T.C. Memo. 1977-170. If the right is not exercised, the taxpayer may be entitled to a loss deduction under section 165 of the Code when the right expires. *See* Rev. Rul. 73-191, 1971-1 C.B. 77.

Rev. Rul. 81-160 at 313.

, (b)(5)(DP)
[redacted]

, (b)(5)(DP)
[redacted]

, (b)(5)(DP)

[redacted]

During the examination, the taxpayer advanced three arguments to support its position against capitalization. First, the taxpayer maintains that Rev. Rul. 81-160 does not apply to the facts in this case. According to the taxpayer, Rev. Rul. 81-160 and the earlier Rev. Rul. 56-136 each address construction financing, in which fixed amounts of credit were made available in stated amounts over specified time periods and ultimately became permanent financing. The commitment fees in each of these rulings were calculated on the amount of available, unissued credit. The commitment fees ended when the full amount of the construction financing was advanced and the bonds became permanent financing.

The taxpayer suggests that the commitment fees addressed in these rulings are more akin to loan origination costs than recurring facility fees. According to the taxpayer, the construction financing described in the rulings was, in effect, a series of predetermined loans, and the commitment fees should be viewed as a series of predetermined loan origination fees computed by reference to the credit to be extended. The commitment fees ceased when the loans were fully extended, even though the loans would remain in place for some time pursuant to the terms of the bonds.

According to the taxpayer, the Agreement in this case is distinguishable from the bond sale arrangement described in Rev. Rul. 81-160, in that the Agreement provided the taxpayer with available credit, but did not commit the taxpayer to utilize that credit. Moreover, the quarterly fees paid by the taxpayer did not decline as credit was extended under the Agreement; the taxpayer incurred the same quarterly fees regardless of whether, when, or how much credit it utilized during the [redacted]-year term.

To support its position, the taxpayer cites PLR 200043015, PLR 00043016, PLR 200043017, PLR 200044005, PLR 8413004, and GCM 39201. These authorities all involve real estate construction financing. Based on these rulings, the taxpayer concludes that Rev. Rul. 81-160 does not apply to a manufacturing and distribution business that maintains a revolving line of credit and enters into letters of credit in the ordinary course of its business.

The taxpayer further notes that at the time Rev. Rul. 81-160 was issued, section 189 required capitalization of interest expenses incurred while real property was under construction. Loan commitment fees or standby charges would not have been subject to capitalization under section 189 because Rev. Rul. 56-136 held that such costs did not constitute interest. The taxpayer asserts that the reasoning behind Rev. Rul. 81-160 may have included the Service's view that a loan commitment fee on a real estate construction project should be subject to capitalization in the same manner as interest on the construction loan. The taxpayer also notes that section 189 was repealed by the Tax Reform Act of 1986 and replaced by the uniform capitalization provisions of section 263A. Thus, according to the taxpayer, because the facility fees are not subject to capitalization under section 263A, the fees should not be subject to capitalization under Rev. Rul. 81-160.

The taxpayer's argument that Rev. Rul. 81-160 and Rev. Rul. 56-136 address construction financing and can therefore only be applied to such types of financing arrangements is misplaced. The taxpayer's argument that the commitment fees addressed in these rulings are more akin to loan origination costs than recurring facility fees is similarly flawed.

Rev. Rul. 56-136 concluded that a commitment fee is not interest and that the fee was deductible under section 162. Rev. Rul. 81-160 revoked Rev. Rul. 56-136 with respect to the deductibility of the commitment fee. Both rulings consider the commitment or standby fees to be something <u>other than interest</u>. Where the two rulings differ is with regard to the deductibility.

Rev. Rul. 81-160 characterizes the charge as an acquisition of a property right. The ruling states:

> A loan commitment fee in the nature of a standby charge is an expenditure that results in the acquisition of a property right, that is, the right to the use of money. Such a loan commitment fee is similar to the cost of an option, which becomes part of the cost of the property acquired upon exercise of the option. Therefore, if the right is exercised, the commitment fee becomes a cost of acquiring the loan and is to be deducted ratably over the term of the loan. <u>See</u> Rev. Rul. 75-172, 1975-1 C.B. 145, and <u>Francis v. Commissioner</u>, T.C.M. 1977-170.

Thus, based on its explicit analogy of commitment fees to option premiums, the Service held that commitment fees are deductible either over the term of the loan (if the borrower draws the available funds) or when the commitment period expires. Although the Service reversed its prior holding in Rev. Rul. 56-136, it does not appear that the Service abandoned the characterization of commitment fees contained in Rev. Rul. 56-136.

In comparing commitment fees to option premiums, the Service's characterization of commitment fees as "the acquisition of the right to the use of money" is consistent with the Service's earlier description of commitment fees in Rev. Rul. 74-258, 1974-1 C.B. 168 (regarding "loan funding" fee income or REITs) as "paid or incurred in consideration of the lender's commitment to lend construction funds rather than in consideration of the borrower's use of the funds."

Rev. Rul. 81-160 is also consistent with Rev. Rul. 56-136 to the extent it characterizes commitment fees as option premiums. In this regard, Rev. Rul. 81-160 may be viewed as somewhat of a technical correction of the Service's position in Rev. Rul. 56-136 to bring the treatment of commitment fees into line with the treatment of option premiums under other revenue rulings. See Rev. Rul. 58-234, 1958-1 C.B. 279; Rev. Rul. 78-182, 78-1 C.B. 265.

Rev. Rul. 81-160 does not presume that the construction loan would be borrowed in full. The issue addressed in the ruling is the characterization of the commitment fees paid. The ruling does make allowance for the occurrence of drawdowns and the effect such drawdowns have on the fees. It also provides for a loss deduction under section 165 if by the end of the commitment term no borrowings took place.

Regarding the taxpayer's section 189 argument (i.e., that section 189 influenced the Services reasoning behind Rev. Rul. 81-160, and that because section 263A, which replaced section 189, does not require capitalization), the taxpayer is wrong. For the foregoing reasons, Rev. Rul. 81-160 applies to any commitment for the availability to provide funds irrespective of the use of such funds. After all, a construction period loan could be considered used for operations by a construction company just as the taxpayer is stating that the purpose of their credit line is for manufacturing operations. If this is the case, then the taxpayer's assumption of the Service's reasoning behind Rev. Rul. 81-160 is misplaced.

Second, the taxpayer argues that the facility fees are currently deductible because the all events test under Treas. Reg. § 1.461-1(a)(2) has been satisfied and economic performance has occurred. According to the taxpayer, the existence and amount of the liability were fixed in the signed Agreement. The taxpayer further maintains that, irrespective of whether the facility fees are viewed as a service or as property provided to the taxpayer, economic performance occurred in [redacted] with respect to the fees paid in that year. From this, the taxpayer concludes that the quarterly fees payable in arrears should be deductible at the end of each quarter.

According to the taxpayer, Treas. Reg. § 1.461-1(a)(2) also provides that other Code provisions, such as section 263, also govern when a liability may be taken into account. The taxpayer asserts that by proposing to disallow the claimed deduction, the Service appears to be asserting that the facility fees should be viewed as a capital expenditure under section 263 and, therefore, not currently deductible. The taxpayer disputes this assertion for a variety of reasons.

Section 263 and Treas. Reg. § 1.263(a)-1(a) provide that no deduction shall be allowed for any amount paid or incurred that add to the value or prolong the useful life of any property owned by the taxpayer. The application of Section 263 has been the subject of considerable controversy. Generally, costs must be capitalized if they create a separate asset. Lincoln Savings and Loan Association v. Commissioner, 403 U.S. 345 (1971). In addition, costs must be capitalized if they produce significant benefits extending past the end of the current tax year. INDOPCO v. Commissioner, 503 U.S. 79 (1992).

According to the taxpayer, the costs of originating the facility in [redacted] did create a capital asset, and these costs have been capitalized and amortized over the useful life. The facility maintenance fees, according to the taxpayer, were just that - the cost of maintaining an existing asset. As argued by the taxpayer, the fees did not create a separate asset or produce significant benefits beyond the end of a tax year. Treas. Reg. § 1.263(a)-(1)(b) provides that amounts paid or incurred for incidental repairs and maintenance are not capital expenditures.

In Rev. Rul. 2001-4, 2001-1 I.R.B 295, the Service held that the cost of heavy aircraft maintenance are deductible, provided they do not materially add to the value of, substantially prolong the useful life of, or adapt the airframe to a new or different use. The taxpayer firmly believes that the facility maintenance fees meet the standards for current deductibility set forth above.

The taxpayer alternatively argues that even if the facility fees are not viewed as maintenance costs, they did not create a separate asset or produce any future benefit to the taxpayer. If the taxpayer did not continue to pay the quarterly facility fees, the facility would have been terminated. Additionally, any utilization of the facility required the taxpayer to pay arm's-length consideration for that utilization in the form of interest or additional fees to the lenders. Therefore, according to the taxpayer, there was no significant future financial benefit created by the facility fees, and that, applying the principle set forth by the Supreme Court in INDOPCO, these costs should been currently deductible under section 162.

The taxpayer's argument is resourceful, but not persuasive. * Under [redacted], the taxpayer has acquired a property right similar to the cost of an option. Loan commitment fees related to the lines of credit are not currently deductible. The annual fees will be capitalized, non-amortizable and will be deducted in the year the credit agreement expires. If the credit line is drawn upon before the expiration date of the credit agreement, an allocation of the fees paid based on the amount of loan created over the $[redacted] line of credit line will then be deducted over the life of the created or remaining loan.

The Service similarly disagrees with the taxpayer's description of the fees as "facility maintenance fees". Section 1.13 of the agreement calls the fee in question a "facility fee". In Rev. Rul. 81-160, the Service concluded that the asset being created is "a property right, that is the right to the use of money". The asset is similar to the cost of an option, which would be part of the cost of the property acquired upon exercise.

There is nothing in the agreement to suggest that the fee in question was intended to compensate the banks for any "maintenance" of the facility. In fact, the agreement appoints one of the banks as an administrator to act as the agent for the banks. The fee is paid to the administrator, who then distributes the fee to the banks providing the revolving credit line. There is a separate fee called the "co-administrative agent's fee" which is paid to the banks administering the agreement. This fact reinforces the Service's position that the facility fee is for the commitment to provide the use of money and not to "maintain" the facility, as suggested by the taxpayer.

*Rev. Rul. 81-160; 1581-1 C 3.312.

According to the financial products specialist, the term "facility fee" is common in the banking industry and does not mean a maintenance fee in the manner suggested by the taxpayer. Rather it is a fee for the bank committing to provide funds. According to Bloomberg.com: Financial Glossary, a "revolving line of credit" is defined as a

> bank line of credit on which a customer pays a commitment fee and can take and repay funds at will. Normally a revolving line of credit involves a firm commitment from a bank for a period of several years.

The facility fee being paid here is similar to the commitment fee, as defined above.

The Service disagrees with the taxpayer's assertion that the payments made in arrears equate to the expiration of an option. Whether the payments were made in arrears or in advance is of no consequence here. The payments were not for the use of money, but rather for the right to borrow. The taxpayer has in fact created an asset that extends beyond the three-month period. The credit line is not available for a three month-period, but for a [redacted]-year period. This is supported by a long-standing position for accounting and tax purposes that automatic renewals are taken into account when computing the useful life of an asset. For example, when a lease agreement is extendable at the option of the lessee, the life of the lease is determined to be the original length plus extensions. The renewal periods were automatic; there was no re-application fee, no credit checks, and no new agreements drafted. Therefore, the payments represent the right to use the money for a [redacted]-year period, and the fact that they are paid quarterly in arrears does not alter the Service's position. The benefit received by the taxpayer is over the life of the line (i.e., [redacted] years), after which time the "option" expires.

Third, as noted above, the taxpayer capitalized the origination costs incurred in [redacted] to secure the Agreement. The authority requiring the capitalization of these loan origination costs also provides that they be amortized over the term of the loan. The taxpayer maintains that it is inconsistent for the Service to accept the [redacted] capitalization, but not the ratable amortization over the loan term. The taxpayer submits that the $[redacted] of costs incurred in [redacted], relating to the preparation and acquisition of the loan agreement, have been properly amortized over the [redacted]-year life of the contract.

Again, we disagree. The costs incurred were relative to the establishment of the revolving line of credit. Since it has been argued that the line of credit produces a property right - the right to the use of the money, which is analogous to an option, there is no loan. If there is no loan, there are no costs to obtain the loan. Therefore, there is no amortization permitted to deduct these costs ratably over the life of the "loan."

A portion of these costs would have been recoverable for the amounts which were actually drawn down during prior years. However, again it must be reiterated that the year under examination is [redacted]. In [redacted] there were no "loans" against the credit line available. Prior drawdowns had been paid back in full. In addition, in [redacted] and [redacted] the corporation received the full benefit of the deduction for the amortization as originally claimed and the commitments fees that were erroneously expensed.

In conclusion, the Service's position is that the payments made were equivalent to option premiums and not currently deductible. The credit line does not represent an obligation, but rather the right to acquire property under Rev. Rul. 81-160. Additionally, the expenses incurred for the cost of acquiring the credit line were not amortizable. Since the credit line is not a "loan", the costs incurred in preparation and acquisition are not deductible or amortizable. Therefore, the amortization expenses of $[redacted] are also not deductible.

We are simultaneously submitting this memorandum to the National Office for post-review and any guidance they may deem appropriate. Consequently, you should not take any action based on the advice contained herein during the 10-day review period. We will inform you of any modification or suggestions, and, if necessary, we will send you a supplemental memorandum incorporating any such recommendation.

This writing may contain privileged information. Any unauthorized disclosure of this writing may have an adverse effect on privileges, such as the attorney-client privilege. If disclosure becomes necessary, please contact this office for our views.

Since there is no further action required by this office, we will close our file in this matter ten days from the issuance of this memorandum or upon our receipt of written advice from the National Office, whichever occurs later.

Please call [redacted] at [redacted] if you have any questions or require further information in this matter.

[redacted]
Associate Area Counsel
LMSB, Area [redacted]

By: ____________________
CARMINO J. SANTANIELLO
Attorney